No. 84-1274

In the Supreme Court of the United States

OCTOBER TERM, 1984

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM, PETITIONER

v.

DIMENSION FINANCIAL CORPORATION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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I. THE COURT OF APPEALS' DECISION WILL HAVE A FUNDAMENTAL IMPACT ON THE NATION'S FINANCIAL SYSTEM

1. As shown in the petition, this case should be reviewed by the Court because the court of appeals' invalidation of the Board's regulatory definitions of "demand deposits" and "commercial loans" as used in the definition of "bank" in the Bank Holding Company Act of 1956 (BHCA or Act), 12 U.S.C. 1841 *et seq.*, will have a fundamental and far-reaching impact on the basic structure of the nation's financial system. As the petition explains (at 22-24), the Board's definitions are designed to restrain the

growth of the nonbank bank device as a method of evading the regulatory restrictions of the BHCA aimed at maintaining banks as impartial providers of credit and at preventing conflicts of interest, concentration of resources, unfair competition, and unsound banking practices. The nonbank bank loophole permits a fundamental restructuring of the banking industry by allowing the unrestricted combination of banking organizations with firms engaged in nonbanking activities of all kinds as well as the unfettered growth of interstate networks of banks—all without congressional approval. This development, which is proceeding apace, has included the widespread acquisition of banks by securities underwriters and dealers, despite this Court's concerns about preventing conflicts of interest and other unsound practices that can result when banks and the securities business are combined.[1] Unless these widespread developments are contained, the nation's financial system will be adversely affected by the breaching of the prudential barriers [redacted] separating banking and commerce. Federal Reserve Board Chairman Volcker summed up the Board's concerns about the effects of nonbank banks on the financial system:

> The consequences are obvious and serious. * * * The pervading atmosphere of unfairness, of constant stretching and testing of the limits of law and regulation and of circumvention of their intent, and of regulatory disarray is inherently troublesome and basically unhealthy.

Moratorium Legislation and Financial Institutions Deregulation: Hearings on S. 1532, S. 1609 and S. 1682 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 1st Sess. 146-147 (1983) (testimony of Board Chairman Volcker).

[1] See *Securities Industry Ass'n* v. *Board of Governors*, No. 82-1766 (June 28, 1984), slip op. 6-10; see also *Investment Co. Institute* v. *Camp*, 401 U.S. 617, 629-634 (1971).

a. Respondents do not deny that the nonbank bank device will have a significant impact on the nation's financial system but attempt to show that the Board's definitions are the cause of the disruption. These attempts are wholly without merit. Respondents err in asserting that the Board's definitions, by treating certain privately insured savings and loan associations that offer banking services as "banks" under the Act and thus requiring them to obtain federal deposit insurance, will wrongfully undermine the private deposit insurance system. The Board's definitions require federal deposit insurance for certain state-chartered savings and loan associations that are owned by companies and that are insured by private corporations only if the associations choose to exercise recently-granted, broad new powers that are functionally equivalent to the powers of a commercial bank. In 1982, Congress expressly excluded *federally insured* state-charted savings and loan associations, which have the same powers as their privately insured counterparts, from the BHCA's definition of bank. Pub. L. No. 97-320, § 333, 96 Stat. 1504. This exclusion implicitly recognized that these savings institutions may now exercise powers that, but for the exemption, would make them "banks" under the BHCA. See S. Rep. 97-536, 97th Cong., 2d Sess. 55 (1982). Pointedly, the amendment excluding savings and loan associations from the BHCA did *not* extend to *privately insured* institutions. The inference is inescapable that Congress viewed these privately insured associations as "banks" under the Act if they exercise their broad new powers without obtaining federal deposit insurance.

Indeed, dramatic evidence of the problems affecting the financial system that can result from nonbank banks that offer banking services without the safeguards provided by the BHCA, in particular the BHCA's requirement of federal deposit insurance for all banks owned by companies (12 U.S.C. 1842(e)), is the recent bank holiday ordered by the Governor of Ohio temporarily closing all institutions insured by respondent Ohio Deposit Guarantee Fund (ODGF). The temporary closing was ordered in the wake of multimillion dollar runs by depositors on several ODGF insured institutions after the March 9 closing of a Cincinnati savings and loan association insured by the Ohio fund.[2]

b. Moreover, the Board's reluctant approval of the acquisition of several nonbank banks by bank holding companies (Br. in Opp. 6-8) demonstrates the importance of the decision below. Each nonbank bank whose acquisition has been approved by the Board has voluntarily agreed not to offer demand deposits as defined in the challenged regulation, or not to make commercial loans as defined by the Board. In addition, the Board has imposed conditions prohibiting the joint operation of the nonbank bank and affiliated companies, in order to effectuate, at least for bank holding companies, the objectives of the Act.[3] These

[2] N.Y. Times, Mar. 16, 1985, at 1, col. 1; Wash. Post, Mar. 16, 1985, at 1, col. 1. The failure of the Cincinnati institution reportedly could exhaust the private ODGF's entire assets, prompting the State of Ohio to enact emergency legislation to create a new state funded and directed insurance fund for other thrift institutions insured by ODGF. Wall St. J., Mar. 14, 1985, at 8, col. 1; *id.* Mar. 12, 1985, at 3, col. 2; Am. Banker, Mar. 13, 1985, at 1, col. 4.

[3] See *e.g., U.S. Trust Corp.*, 70 Fed. Res. Bull. 371, 372 (1984) (nonbank bank will not make commercial loans as defined in Regulation Y); *Irving Bank Corp.*, 71 Fed. Res. Bull. 173, 173-174 (1985) (nonbank banks will not accept demand deposits as defined in Regulation Y).

restrictions on the operations of nonbank banks prevent these institutions from offering checking account and commercial lending services that are functionally equivalent to the services offered by banks covered by the Act. The Board's definitions thus represent a tangible and realistic deterrent to the growth of the nonbank bank as a device to circumvent the BHCA, although the definitions have not (and cannot without legislation) close the nonbank bank loophole entirely. Unless the decision of the court of appeals is reversed, the economic benefit of owning a depository institution that can provide all of the essential services of banking without being subject to the Act will become virtually irresistible and nonbank banks will be a significant, permanent feature of the nation's financial system.

In any event, the Board's approval of nonbank bank acquisitions shows conclusively that the Board has not usurped any legislative function. Each of the Board's approval orders expressly recognizes that legislation is necessary to extend the BHCA to all nonbank banks and that an institution that in reality does not accept demand deposits or does not make commercial loans is not a bank under the Act as currently written.[4] *E.g., U.S. Trust Corp.*, 70 Fed. Res. Bull. 371, 373 (1984).

[4] The moratorium legislation supported by the Board would have in effect temporarily amended the definition of "bank" in the BHCA to cover any institution insured by the FDIC (Br. in Opp. 11-12). As demonstrated by the Board's orders approving nonbank bank acquisitions, the Board has not treated all insured bank as "banks" for BHCA purposes and thus has not attempted to accomplish administratively what Congress has declined to do by legislation.

2. Contrary to respondents' assertions (Br. in Opp. 6), there is no reliable evidence that legislation dealing with the growth of nonbank banks will receive congressional attention in the near future. Bills to close the nonbank bank loophole have been introduced since at least 1983 and, despite virtually uniform agreement among legislators that the loophole should be closed, none of these bills has been enacted. Indeed, some banking law commentators have suggested that legislation extending coverage of the BHCA to nonbank banks will not be adopted until 1986, if at all, or perhaps not even until the 100th Congress (beginning in 1987), due in part to the emergence of other developments in the banking industry also in need of legislative attention.[5] Given their importance for the nation's financial system, the issues raised by the court of appeals' decision should be resolved now and not by exploitation of loopholes.

II. THE BOARD'S DEFINITIONS ARE LAWFUL UNDER THE BHCA

1. With respect to the Board's definition of "demand deposits" to include Negotiable Order of Withdrawal (NOW) checking accounts, the petition demonstrates that the legislative history of the Act is replete with references describing demand deposits as checking accounts and that, notwithstanding a never-exercised prior notice of withdrawal requirement applicable to NOW accounts, these accounts are checking accounts that operate in the same manner as conventional demand checking deposits (Pet. 10-15).

Respondents' contentions concerning the inclusion of NOW accounts in the Board's definition of "demand deposits" are at odds with the statutory language, distort the legislative history, and ignore the fact that in actual operation NOW accounts are substantively indistinguishable from conventional demand deposits. Section 2(c) of the BHCA, 12 U.S.C. 1841(c), refers to deposits that the depositor "has a legal right to withdraw on demand." As the Board has recognized,[6] a NOW account depositor in effect has a legal right to withdraw funds from the account by check on demand until the depository institution actually requires prior notice of withdrawal, a requirement that with respect to NOW accounts, has not been and cannot ever practically be invoked (see Pet. 12-13 & n.7).

Contrary to respondents' claim (Br. in Opp. 15-18), the legislative history of the 1966 amendment to the BHCA incorporating the demand deposit test into the Act's definition of "bank" demonstrates that the ability to make withdrawals by check was viewed as the determinative factor of "demand deposits" as used in the amendment. The Board's 1963 interpretation concerning institutions that would be "banks" as defined in the Act as originally enacted distinguished between two categories of deposits based, not on the existence of a notice of withdrawal requirement, but on the method by which withdrawals could be made: deposits "subject to check" or deposits not subject to check but that "otherwise * * * in actual practice [are] repaid in demand." 49 Fed. Res. Bull. 166 (1963). NOW accounts would clearly have fallen in the first category of deposits, *i.e.*, deposits subject to check.[7]

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[5] Hawke, *Nonbank Banks Should Get Down to Business*, Am. Banker, Nov. 15, 1984, at 4, col. 1.

[6] *First Bancorporation (Beehive Thrift & Loan)*, 68 Fed. Res. Bull. 253, 253 (1982).

[7] Respondents' reading of the legislative history is apparently premised on the unsupported assumption that the 1963

In 1966, the Board endorsed legislation to amend the definition of "bank" to cover only an institution that receives deposits "payable on demand." The Board stated that this proposal would cover institutions "that offer checking accounts" and exclude institutions that accept deposits that are paid on demand. *Amend the Bank Holding Company Act of 1956: Hearings on S. 2353, S. 2418 and H.R. 7371 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 89th Cong., 2d. Sess. 447 (1966) [hereinafter cited as *1966 Hearings*]. This proposal was plainly meant to continue coverage of the deposits in the first category described in the Board's 1963 interpretation (deposits subject to check) and to exclude from coverage deposits in the second category—*e.g.*, passbook and statement savings accounts.

The Board's proposal was in substance enacted. Although the language in the bill reported by the Senate Banking Committee (and later enacted) referred to covered deposits in terms of a legal right to withdraw on demand, the Committee's report explained this language as covering deposits "payable on demand (checking accounts)," precisely the terminology the Board had proposed.[8] S. Rep. 1179, 89th Cong., 2d Sess. 7 (1966).

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interpretation distinguished between the two classes of deposits on the basis of whether the institution reserved the right to require advance notice of withdrawal from the deposit. However, nothing in the Board's 1963 interpretation (or in the subsequent history) specifically mentions a prior notice of withdrawal requirement.

[8] The fact that the 1966 amendment was intended to exclude industrial banking organizations from coverage as "banks" under the Act does not support respondents' contentions. In seeking the exclusion of industrial banking organizations from the Act, industry representatives expressly advised Congress that these institutions "make direct loans * * * to *consumers*" and *"do not accept checking accounts."* *1966 Hearings* 155, 157 (emphasis added). Today, however, many industrial banks offer precisely these services.

Respondents do not contest the fact that NOW accounts are checking accounts and in reality are used for the same purposes and in the same manner as conventional demand deposits. The fact, relied on by respondents, that NOW accounts generally bear interest and are not available to all depositors does not prevent these accounts from being used as a device to circumvent coverage of the BHCA. By offering NOW accounts in place of conventional demand deposits, nonbank banks will be able to provide in practice exactly the same checking account and commercial lending services provided by many commercial banks subject to the BHCA. According to data compiled by the Board, many smaller commercial banks now covered by the BHCA provide essentially consumer-oriented services and as a result hold only a small proportion of their deposits in non-interest-bearing, business checking accounts.[9] Thus, the offering of non-interest-bearing accounts to businesses is not a critical aspect of the banking functions intended to be covered by the Act.[10]

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[9] At about 1900 commercial banks (excluding nonbank banks), which is more than ten percent of all commercial banks in the country, the total amount of conventional demand deposits is less than ten percent of assets. According to statistics maintained by the Board, the amount of conventional demand deposits held by businesses typically constitutes about half of total demand deposits.

[10] Equally misplaced is respondents' reliance on the current definitions of "demand deposit" in the Board's Regulations D and Q, which relate, respectively, to the maintenance of reserves and to maximum interest rates payable on deposits by

2. The Board has also shown that the BHCA does not define the term "commercial loans," that this term is not explained in the legislative history, and that each money market instrument included in the Board's definition can reasonably be viewed as a loan to a commercial enterprise (Pet. 15-19). Respondents do not contest the Board's findings on the economic characteristics of the money market instruments included in the definition of "commercial loans," but assert that Congress meant that term to include only commercial loans as traditionally defined, *i.e.*, loans to a nonbanking enterprise that involve direct negotiations between the borrower and lender (Br. in Opp. 22-23). This test is inconsistent, however, with traditional practices in the banking industry, as well as with the purposes and legislative history of the BHCA.

A bank's purchase in the open market of commercial paper, a money market instrument included within the Board's definition of "commercial loans," traditionally has been considered to be the making of a commercial loan by the purchasing bank. Indeed, both today and in 1970, when the "commercial loans" test was added to the BHCA, commercial paper purchased by a bank in the open market is uniformly

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depository institutions. 12 C.F.R. Pts. 204, 217. At the time the demand deposit test was added to the BHCA, the definitions in the Board's Regulations D and Q contained provisions prohibiting withdrawals by check from savings accounts and NOW account thus would have been considered demand deposits. See 26 Fed. Reg. 12031 (1961). Moreover, regardless of the technical classification of NOW accounts for purposes of the definitions in Regulations D and Q, NOW accounts are treated substantively far differently than ordinary savings accounts. Depository institutions offering NOW accounts must maintain the same level of reserves with respect to NOW accounts as are maintained with respect to conventional demand deposits. 12 C.F.R. 204.2(e), 204.8.

reported in banks' published balance sheets in the category of "commercial and industrial loans." [11] Respondent's theory would preclude even this type of traditional, open market commercial lending vehicle from being treated as a commercial loan for purposes of the BHCA's definition of "bank." [12]

In addition, respondents' proposed test of "commercial loans" is not consistent with the purposes for which Congress enacted the BHCA. It is manifest that the BHCA was not enacted to accomplish a single objective but to effectuate a comprehensive set of goals: to eliminate preferential treatment in commercial lending; to prevent the concentration of control over banking facilities, in particular, by generally barring the establishment of interstate networks of banks; to protect customers of banks from the tying of credit to other services offered by the bank or an affiliate; and to prevent threats to the solvency of banks from unsafe practices by holding company affiliates.[13] In order to effectuate these goals, the term "commercial loans" must be interpreted as broadly as is consistent with the meaning of the language.

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[11] See C.A. Pet. Joint Reply Br. App. 1793.

[12] Respondents have no answer for the Board's finding (Pet. 18) that a substantial portion of the money market transactions included in the Board's definition of "commercial loans" in fact are conducted by means of direct negotiations between the borrower and lender without the use of intermediaries, and thus would qualify as commercial loans even under the narrow test asserted by respondents.

[13] 12 U.S.C. 1843(a), 1842(a), (c) and (d), 1971-1978, 1844(c); S. Rep. 1095, 84th Cong., 1st Sess. 2, 4-5, 14, 16 (1955); S. Rep. 91-1084, 91st Cong., 2d Sess. 2-4, 47-48 (1970); H.R. Rep. 91-1747, 91st Cong., 2d Sess. 11 (1970) (Statement of the Managers on the Part of the House).

Nor can respondents' asserted test of commercial lending be supported by reference to the activities of the Boston Safe Deposit & Trust Company, the company Congress was informed would be the beneficiary of the commercial lending exception. Respondents have not identified a scrap of evidence even suggesting that Congress was aware of all of the activities of Boston Safe. Indeed, since it is now clear that at the time of the commercial loan amendment Boston Safe purchased commercial paper, a transaction uniformly understood then (as now) as the making of a commercial loan, Congress could not have been aware of all of that company's activities, otherwise Congress would not have chosen commercial lending as the test for excluding that institution from the Act. The commercial lending amendment was not a private bill to exclude Boston Safe but instead an exception for institutions not engaged in making commercial loans, a term left undefined that must be interpreted in light of the overall purposes of BHCA.

Given the complete lack of support in the statute, its history and purposes for the view that direct negotiations between a lender and borrower are the determinative factor of a "commercial loan" as used in the BHCA, the Board acted reasonably in rejecting earlier interpretations that embodied that distinction. Contrary to respondents' contentions, the reexamination of the meaning of "commercial loans" as used in the Act's definition of "bank" resulted from the recent widespread use of the nonbank bank device to escape the Act's coverage, which forced the Board to look anew at the proper scope of the exemption for

non-commercial lenders to assure that the purposes of the Act are fully effectuated.[14]

3. Respondents' reliance (Br. in Opp. 12-13) on the views of the other federal banking agencies with respect to the Board's definitions is misplaced. The other agencies are not charged with administration of the BHCA and, accordingly, their views on the scope of that legislation are not entitled to any significant weight. This Court has repeatedly made clear that Congress gave the Board exclusive jurisdiction to interpret provisions of the BHCA and that the Board's jurisdiction is paramount. *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234, 250-251 (1978); *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 379 U.S. 411, 419-420 (1965). Moreover, the weight to be accorded the views of the Treasury Department, which assume that nonbank banks are permissible under current law (Br. in Opp. Addendum H), is undermined by a recent district court decision casting serious doubt on the Comptroller's authority to charter such institutions.[15] Finally, respondents completely ignore

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[14] Respondents' assertion that the Board failed to provide an opportunity for public comment on the rationale for its definitions of "demand deposits" and "commercial loans" is without foundation. Prior to adopting the definitions, the Board published for comment in the *Federal Register* the text of the proposed definitions accompanied by a commentary that expressly incorporated the findings and reasoning in the Board's rulings in its *First Bancorporation* and *Dreyfus Corp.* decisions, which the proposed regulatory provisions were meant to codify. 48 Fed. Reg. 23520 (1983).

[15] *Independent Bankers Ass'n of America* v. *Conover*, No. 84-1403-CIV-J-12 (M.D. Fla. Feb. 15, 1985), slip op. 39 (order granting preliminary injunction) ("The Comptroller does

the views of state bank regulators, many of whom vigorously support the Board's adoption of the definitions of "demand deposits" and "commercial loans" (see Pet. 23).

For these reasons and the reasons stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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I authorize the filing of this brief.

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not serve the public interest by issuing charters to nonbank banks when their only conceivable purpose is to enable their parent companies to escape regulation under the BHCA.").

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